Internal Revenue Service

memorandum

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to: R.H. Gannon, District Counsel (Los Angeles)

from: David I. Bower, Senior Attorney CC:INTL:Br6
DIB

subject: [redacted] - Oil Swap Sourcing Issue

This memorandum responds to your request to Kim Palmerino of our office for informal technical assistance on the above referenced topic. Information set forth in this memorandum was obtained from the revenue agents auditing [redacted]. As set forth below, additional facts need to be established before a definite answer can be given to some of the issues presented.

Issue Presented

What are the best theories available for resourcing income from sales of bargain purchase foreign oil to the domestic oil sales from which the bargain purchase element was derived?

Conclusion

The best available theory is an argument that actual consideration equal to the bargain element was received in the domestic oil sales. An alternative, more creative argument might be made under section 1.482-2 that the purchaser of the foreign oil owes a fee to the seller of the domestic oil for arranging the purchase of the foreign oil at the bargain price.

Background

[redacted] is a domestic corporation which operates in the U.S. through divisions. During years [redacted] s [redacted] producing division extracted oil from [redacted] and [redacted]. DOE subjected this oil to certain resale restrictions as to price and purchaser. [redacted] arranged for quantities of this oil to be sold to a U.S. affiliate of [redacted] or other unaffiliated oil traders at the DOE restricted price. This price was lower than the price at which the oil could have been sold on world markets absent DOE restrictions.

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DOE conducted an investigation of these transactions. DOE concluded that the [redacted] group disposed of the domestic oil in a manner which violated DOE restrictions. The [redacted] group received additional consideration for these domestic oil sales. The traders who purchased the domestic oil agreed to sell, and did sell, to a domestic [redacted] subsidiary (the "[redacted] trader") equivalent quantities of foreign oil at a discount from the world market price for such oil. The amount of the discount was designed to return to the [redacted] group the amount [redacted] would have received if the [redacted] domestic oil was sold without being subject to the DOE restrictions, i.e. at its fair market value.

The [redacted] trader then proceeded to sell some of the foreign oil to [redacted] affiliates and some to unaffiliated parties. The price of the oil was its fair market value. The net effect was the sale of the domestic oil at its fair market value. An example using hypothetical numbers demonstrates the transactions.

[redacted] sells [redacted] barrels of domestic oil to [redacted] at $[redacted] per barrel. The oil could fetch $[redacted] per barrel on the open market. [redacted] then sells to [redacted] trader [redacted] barrels of Saudi oil at $[redacted] per barrel, $[redacted] per barrel less than its fair market value of $[redacted]. [redacted] trader then disposes of the [redacted] barrels of Saudi oil at $[redacted] per barrel. The net result is that [redacted] trader has $[redacted] of income, ostensibly from disposing of Saudi oil. However, DOE found that this $[redacted] profit was in reality derived from the domestic oil, and ordered remedial measures to be taken by [redacted] since the linked transactions were designed to circumvent DOE rules.

For tax purposes, all of this income was included on the U.S. return. However, since the domestic oil was sold to U.S. persons F.O.B. U.S. ports, it is U.S. source income. Some of the foreign oil was sold to third parties and, under the title passage rule of section 1.861-7, it was sourced foreign. The effect of this "resourcing" of the income, which according to the DOE report was attributable to the domestic oil, was to increase the numerator of [redacted]'s section 904 fraction and thereby increase its available foreign tax credits.

For years [redacted]-[redacted], similar transactions were engaged in with respect to [redacted] oil, which was also subject to DOE restrictions until [redacted]. Thus the same

"resourcing" problem is presented with respect to those years.

Discussion

Assuming that the DOE report establishes that the domestic sales and foreign purchases were indeed linked, the issue presented is: What is the best available legal theory for treating the [redacted] trader's foreign source foreign oil sales income as U.S. source income?

1. Title Passage Regulations.

We agree with your analysis that any argument that the title passage rule does not apply here is unlikely to succeed since there is no evidence of a primary purpose of tax avoidance. See your memorandum to Ray Collins, 12/20/88/ p. 2. However, such a purpose may exist in years when there were no DOE restrictions in place.

2. Allocation and Apportionment Regulations.

Section 1.861-8 of the income tax regulations can not be used to make adjustments to the [redacted] trader's cost of goods sold. Cost of goods sold is deducted from gross revenue of a trade or business utilizing an inventory method of accounting to arrive at gross income. See Pittsburgh Milk Co. v. Comm'r, 26 T.C. 706 (1956), and its progeny (illegal rebates are adjustments to gross revenue in computing gross income); see also section 61(a)(3) (gross income includes gains derived from dealings in property (emphasis added)). Section 1.861-8 only applies to computations which transform gross income into taxable income. Section 1.861-8(a)(1). Accordingly, an attempt to use section 861-8 to adjust the [redacted] trader's cost of goods sold is unlikely to succeed.

3. Form over Substance.

Our use of this label to describe [redacted]'s transactions is likely to result in the taxpayer making the following argument. If the domestic sales and foreign purchases were linked, then the net result is the sale of the domestic oil to the purchasers of the foreign oil. If the term "form over substance" is used in its typical sense of ignoring intermediate transactions which do not have independent significance, the taxpayer will prevail because the actual title passage mechanics of the foreign oil sales will control, regardless of the fact that if such sales were of

domestic oil they would have violated DOE controls. Accordingly, the argument should be phrased somewhat differently, as presented in the next section.

4. Linked sales show additional consideration.

The DOE report should be able to show that [redacted] in effect sold the domestic oil for the stated cash consideration plus a right to acquire bargain purchase foreign crude oil. This right had value and this is the basis of imputing additional domestic source income to [redacted]. Theoretically the value of this right to purchase foreign oil is the discount from the fair market value which was used to establish the purchase price of the foreign oil.[1] This contract right would be taxed to [redacted] parent and treated as a capital contribution to the [redacted] trader, increasing its cost of goods sold, i.e., the foreign oil.

5. Fee for Services.

An alternative, and more technical, explanation of the linked transactions may bolster the argument in paragraph 4. It should be possible to use the provisions of section 1.482-2(b)(7)(iii) to argue that [redacted] parent is owed a fee by [redacted] trader for arranging the delivery of bargain purchase foreign oil to [redacted] trader. In order for this regulation to apply, the [redacted] parent must have been peculiarly capable of providing the services and the cost of doing so must have been substantially exceeded by the value of the services to the recipient. Under this argument, [redacted] parent was peculiarly capable of providing [redacted] et. al. with the oil it wanted, i.e. domestic certified oil. The value [redacted] [redacted] et. al. placed on this domestic oil was the offer to sell foreign oil to [redacted] at a discount. Without [redacted] parent's ability to provide the domestic oil, the [redacted] trader never would have received the right to buy the discounted oil. Thus [redacted] parent was peculiarly capable of providing the service of arranging the transaction.

There is almost no authority discussing section 1.482-2(b)(7)(iii). The three illustrative examples of "peculiarly capable" situations contained in the regulations all pertain to the use of intangible or service skills, situations which are not applicable to the [redacted] facts. However, that list is

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[1] There may be problems of proof on this, which I leave for your determination.

illustrative and not exclusive. See undated technical memorandum in the file LR-482-2, X-1. If the unique value of the [redacted] domestic oil can be demonstrated, then it may be possible to use this regulation. The remainder of the services regulations as applied to these facts would result in the fee being equal to [redacted] parent's costs, presumably a low figure since costs do not include "opportunity" costs, i.e., the value without DOE restrictions of the domestic oil.

The amount of the fee is a separate issue, but it should be substantially all of the bargain element of the foreign oil purchase price. This finding is crucial, because the value of the service must substantially exceed its cost to the renderer under section 1.482-2(b)(7)(iii). Thus the cost of this service, in terms of personnel time, negotiating incidentals, et., should substantially exceeded by the value of the right conveyed to [redacted] trader, the bargain element in the foreign oil purchase price.

6. First Security Bank of Utah v. Comm'r.

Both arguments 4 and 5 may be subject to attack under First Security Bank of Utah v. U.S., 405 U.S. 894 (1972), holding that the allocation by the IRS of commission income received by an insurance company to its banking affiliate was prohibited where the receipt of those commissions by the banking affiliate directly was illegal under state law.[2]

Under the argument advanced in paragraph 4, it may be possible to distinguish First Security by pointing out that under our analysis [redacted] parent (1) did violate the law (DOE finding) and (2) did in fact receive the income in question in the form of the contracts to purchase foreign oil at a discount. The majority in First Security held that no violation of law occurred because the bank did not receive the commissions.

Under the argument advanced in paragraph 5, it could be argued that the service of negotiating the tied contracts and arranging for the discount were provided to [redacted] trader by

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[2] I believe that one of the mistakes in the IRS argument in that case was to state that the commissions were being reallocated. It would have been more appropriate to allocate a service fee to the bank, although the value of that fee under the services regulation (section 1.482-2(b)) may have been cost, not the amount of the insurance commissions.

[redacted] parent, and constitute U.S. source income if those services were provided in the U.S. Income from providing oil placement services arguably is not governed by DOE regulations and therefore would not be subject to First Security.

Assuming that the DOE evidence is sufficiently strong, we believe you should proceed along the lines suggested in paragraphs 4 and 5. For years in which DOE controls were not in effect, it may be more difficult to prove linkage, but the same analysis should apply. See also the theories in paragraph 1 above.

7. Additional points. The strength of this case will depend in large part on the nature of the findings in the DOE report. It should be carefully scrutinized so that the argument we make is crafted to make the best use of the facts in the DOE report, and theories inconsistent with those facts should be modified or dropped. If you have any questions or if we can be of further assistance in the development of this case, please contact either Kim Palmerino (FTS 566-6307) or David I. Bower (FTS 634-5415).

cc: Ray Collins, ISTA, San Jose, CA